Investment-Grade Corporate Bonds

Strong Technicals Support IG

Despite weakening fundamentals, the performance outlook appears positive.

Despite early signs of deterioration in credit fundamentals, investment-grade credit spreads should continue to be supported over the third quarter by strong technicals, lack of volatility, and historically attractive all-in yields. Primary supply technicals remain favorable. While there continues to be a dearth in long duration and bank issuance, we expect banks to pick up the pace in the third quarter, but issuance of longer duration securities is likely to remain muted.

The traditional investor base for investment-grade corporates has been underweight versus the benchmark due to defensive positioning, but positive mutual fund inflows into high-grade funds should help keep spreads rangebound throughout the third quarter. The yield on the Bloomberg U.S. Investment Grade Corporate Index was hovering just above 5.5 percent in mid-July, which is in the 98th percentile over the last 10 years. We believe this relatively higher yield offers plenty of insulation from a total return perspective: Spreads would need to widen or rates increase by a combined 78 basis points in order to generate a loss over a one-year time horizon. But sectors such as money market funds and short-term Treasurys and Agencies are attractive alternative investments in the 4.75–5 percent yield range, which is likely to prevent investment-grade spreads from tightening materially from current levels.

Second quarter earnings show weakening credit fundamentals, as margins continue to compress and interest coverage trends lower as funding costs have risen. That said, the decline has been measured and these indicators are generally still above pre-COVID levels, but we expect this trend to continue and possibly accelerate into year-end.

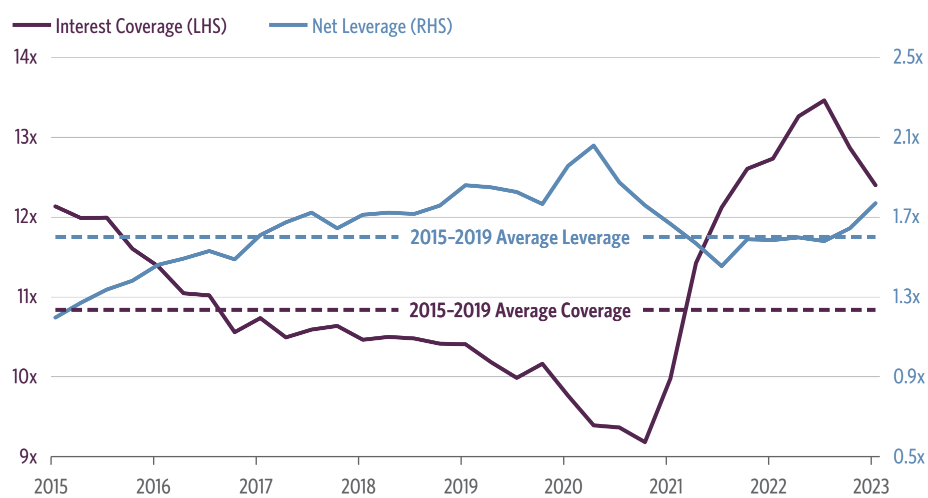
Despite the 10s/30s credit curve continuing to flatten on a yield basis, we still see value in long duration securities. The supply technicals and natural buyer base for 30-year paper should continue to support the market throughout the third quarter. We remain cautious about adding to preferred and junior subordinated securities in the secondary market until further clarity around bank regulatory capital is finalized. However, we believe there are certain attractive investments in the asset class with higher current coupon and/or higher reset spread securities, which offer less downside risk. As we enter the summer slowdown, we believe more focus should be on liquidity and diversification.

By Justin Takata

Credit fundamentals are weakening as margins continue to compress and interest coverage trends lower as funding costs rise.

Investment-Grade Credit Fundamentals are Deteriorating Gradually

Interest Coverage Ratios and Net Leverage Ratios



Source: Guggenheim Investments, Morgan Stanley Research. Data as of 3.31.2023.

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